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**BEFORE THE ARIZONA CORPORATION COMMISSION**

IN THE MATTER OF THE  
APPLICATION OF BLACK MOUNTAIN  
SEWER CORPORATION, AN ARIZONA  
CORPORATION, FOR A  
DETERMINATION OF THE FAIR  
VALUE OF ITS UTILITY PLANT AND  
PROPERTY AND FOR INCREASES IN  
ITS RATES AND CHARGES FOR  
UTILITY SERVICE BASED THEREON.

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Arizona Corporation Commission

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**BLACK MOUNTAIN SEWER CORPORATION'S**

**REPLY BRIEF**

**September 5, 2006**

ARIZONA CORPORATION COMMISSION  
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## TABLE OF CONTENTS

		Page
1		
2		
3	I. INTRODUCTION .....	1
4	A. Brief Summary Of Request For Relief.....	1
5	B. Nature Of Proceedings .....	1
6	II. THE RECORD BEFORE THE COMMISSION DOES NOT SUPPORT	
7	WITHHOLDING OR CONDITIONING RATE INCREASES IN THE	
8	MANNER RECOMMENDED BY THE TOWN AND HOA.....	3
9	A. The Relief Sought By The Town And HOA Is Unsupported .....	3
10	B. The Claims Made By The Town And HOA Are Too Vague To	
11	Support The Relief Sought .....	5
12	C. The Relief Sought By The Town And HOA Is Unnecessary .....	6
13	III. RATE BASE ISSUES IN DISPUTE WITH STAFF .....	7
14	IV. ALL THREE OF RUCO'S ADJUSTMENTS TO LOWER RATE BASE	
15	SHOULD BE REJECTED. ....	8
16	A. RUCO's Deferred Tax Liability Is A Work Of Fiction .....	8
17	B. BMSC's Working Capital Allowance Should be Zero .....	9
18	C. RUCO Has Not Presented Compelling Reasons To Change The	
19	Commission-Ordered Treatment Of Past Payments For Wastewater	
20	Treatment.....	10
21	V. INCOME STATEMENT ISSUES IN DISPUTE.....	12
22	A. RUCO's Challenge To Property Tax Expense Should Be Rejected,	
23	Again .....	12
24	B. Staff's Recommended Rate Case Expense Is Unfair To BMSC.....	13
25	VI. STAFF HAS NOT DEMONSTRATED THAT THE TOTAL COSTS OF	
26	AFFILIATED SERVICES ARE UNREASONABLE.....	15
	A. Staff Failed To Conduct An Actual Analysis Of The Affiliated	
	Transactions.....	16
	B. Where Is The Harm? .....	18
	C. The Only Evidence Before The Commission Shows That BMSC's	
	Payments To Affiliated Companies Are Reasonable – Therefore	
	They Should Be Allowed .....	20

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26

**TABLE OF CONTENTS**  
(continued)

	<b>Page</b>
VII. CAPITAL STRUCTURE AND COST OF CAPITAL .....	21
A. RUCO's Hypothetical Capital Structure Should Be Rejected .....	21
B. BMSC's ROE Should Be 11 Percent. ....	22
VIII. BMSC SHOULD BE AUTHORIZED TO MAKE REFUNDS OF HOOK UP FEES TO RATEPAYERS.....	24

1                                   **BLACK MOUNTAIN SEWER CORPORATION**  
2                                   **PRE-FILED TESTIMONY**

3    **Pre-Filed Testimony**                                   **Hearing Exhibit**                                   **Abbreviation**

4    Direct Testimony of                                   A-1                                   Bourassa DT  
    Thomas Bourassa

5    Rebuttal Testimony of                                   A-2                                   Bourassa RB  
6    Thomas Bourassa

7    Rejoinder Testimony of                                   A-3                                   Bourassa RJ  
    Thomas Bourassa

8    Direct Testimony of                                   A-4                                   Weber DT  
9    Mike Weber

10   Rebuttal Testimony of                                   A-5                                   Weber RB  
    Mike Weber

11   Redacted Rebuttal Testimony of                                   A-6                                   Wade RB  
12   Joel Wade

13   Redacted Rejoinder Testimony of                                   A-7                                   Wade RJ  
14   Joel Wade

15  
16                                   **TOWN OF CAREFREE PRE-FILED TESTIMONY**

17   **Pre-Filed Testimony**                                   **Hearing Exhibit**                                   **Abbreviation**

18   Affidavit of Stan Francom                                   T-1                                   Francom AF

19   Surrebuttal Testimony of                                   T-2                                   Francom SB  
    Stan Francom

20   Direct Testimony of                                   T-4                                   Pearson DT  
21   Jonathan Pearson

22   Surrebuttal Testimony of                                   T-5                                   Pearson SB  
    Jonathan Pearson

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**STAFF PRE-FILED TESTIMONY**

<b>Pre-Filed Testimony</b>	<b>Hearing Exhibit</b>	<b>Abbreviation</b>
Direct Testimony of Marlin Scott, Jr.	S-1	Scott DT
Surrebuttal Testimony of Marlin Scott, Jr.	S-2	Scott SB
Direct Testimony of Pedro Chaves	S-4	Chaves DT
Surrebuttal Testimony of Pedro Chaves	S-5	Chaves SB
Direct Testimony of Crystal Brown	S-9	Brown DT
Surrebuttal Testimony of Crystal Brown	S-10	Brown SB

**RUCO PRE-FILED TESTIMONY**

<b>Pre-Filed Testimony</b>	<b>Hearing Exhibit</b>	<b>Abbreviation</b>
Direct Testimony of Marylee Diaz Cortez	R-11	Diaz Cortez DT
Surrebuttal Testimony of Marylee Diaz Cortez	R-12	Diaz Cortez SB
Direct Testimony of Bill Rigsby	R-13	Rigsby DT
Direct Testimony of Bill Rigsby (Cost of Capital)	R-14	Rigsby DT Cost
Surrebuttal Testimony of Bill Rigsby	R-15	Rigsby SB

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1     **I.     INTRODUCTION.**

2         **A.     Brief Summary Of Request For Relief.**

3             Black Mountain Sewer Corporation ("BMSC") is requesting an increase in  
4     revenue of \$256,065, an increase of 21.24% over test year revenues. BMSC BR at Brief  
5     Ex. 1, Schedule A-1.<sup>1</sup> BMSC initially requested an increase of \$163,279, or 13.52%.  
6     Bourassa RB (Ex. A-2) at 1. After modifying its position and adopting a number of  
7     adjustments in response to the filings by the other parties, BMSC's April 2006, rebuttal  
8     filing requested an increase of \$270,629, or 22.41%, which amount was reduced to  
9     \$268,547 or 22.28% in the Company's May 2006, rejoinder filing. Bourassa RJ (Ex. A-  
10    3) at 1. The Company's final request is lower than the amount requested at the rejoinder  
11    stage (and during the hearing) primarily due to post-hearing adjustments made in  
12    response to post-hearing corrections made by Staff in its relevant rate schedules. *See*  
13    Staff BR at 14-16.<sup>2</sup>

14         **B.     Nature Of Proceedings.**

15             The process and procedures the Commission follows to gather and consider  
16

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17     <sup>1</sup> Citations to the record are made using the same format, abbreviations and conventions  
18     as in the Company's Closing Brief, abbreviated "BMSC BR" herein. Staff's Closing  
19     Brief is abbreviated as "Staff BR", RUCO's Initial Closing Brief is abbreviated as  
20     "RUCO BR", and the Town and HOA's closing briefs are abbreviated "Town BR" and  
21     "HOA BR", respectively. A list of the witnesses' pre-filed testimony is again provided  
22     after the Table of Contents for the Administrative Law Judge's convenience.

23     <sup>2</sup> The HOA's "anticipatory" opposition to the final supporting schedules filed with the  
24     Company's final request is both curious and ironic. *See* HOA BR at 18-19, n. 1. This is  
25     curious because the Company's final request is actually lower than the amount requested  
26     in April 2006, two months before the hearing when the Company was seeking an increase  
   of over 22%. Additionally, the HOA has never submitted or challenged any specific  
   financial information in this rate case. The irony of the HOA's claim that its due process  
   rights are being violated by the post-hearing filing of final schedules should also not go  
   unnoticed. The HOA's scathing portrayal of BMSC is based almost entirely on matters  
   outside the evidentiary record, much of which was not previously disclosed. *See*  
   Section II, *infra*.

1 evidence in setting rates are quasi-judicial in character. *State ex rel. Corbin v. Arizona*  
2 *Corporation Comm'n*, 143 Ariz. 219, 223-24, 693 P.2d 362, 366-67 (App. 1984). In that  
3 case, the Arizona Court of Appeals summarized the procedural requirements for setting  
4 rates as follows:

5           It is a [proceeding] which carries with it fundamental  
6           procedural requirements. There must be a full hearing. There  
7           must be evidence adequate to support pertinent and necessary  
8           findings of fact. Nothing can be treated as evidence which is  
9           not introduced as such. Facts and circumstances which ought  
10          to be considered must not be excluded. Facts and  
11          circumstances must not be considered which should not  
12          legally influence the conclusion. Findings based on the  
13          evidence must embrace the basic facts which are needed to  
14          sustain the order. . . .

15          A proceeding of this sort requiring the taking and weighing of  
16          evidence, determinations of fact based upon the consideration  
17          of the evidence, and the making of an order supported by  
18          such findings, has a quality resembling that of a judicial  
19          proceeding. Hence it is frequently described as a proceeding  
20          of a *quasi judicial* character. The requirement of a 'full  
21          hearing' has obvious reference to the tradition of judicial  
22          proceedings in which evidence is received and weighted by  
23          the trier of the facts. The 'hearing' is designed to afford the  
24          safeguard that the one who decides shall be bound in good  
25          conscience to consider the evidence, to be guided by that  
26          alone, and to reach his conclusion uninfluenced by extraneous  
27          considerations which in other fields might have play in  
28          determining purely executive action. The 'hearing' is the  
29          hearing of evidence and argument.

30 *Id.* at 224, 693 P.2d at 367, citing *Morgan v. United States*, 298 U.S. 468 (1936) (italics  
31 in original).

32           Thus, the Commission's decision must be based on the evidence presented by the  
33 parties in this proceeding, with due regard to the credibility of the witnesses and the  
34 authorities and precedent supporting the parties' positions. In this proceeding, only one  
35 party, BMSC, has presented substantial evidence concerning the contested issues  
36 sufficient to sustain a decision based on the record.

1 **II. THE RECORD BEFORE THE COMMISSION DOES NOT SUPPORT**  
2 **WITHHOLDING OR CONDITIONING RATE INCREASES IN THE**  
3 **MANNER RECOMMENDED BY THE TOWN AND HOA.**

4 The Town and HOA recommend that all rate increases be withheld until, or at  
5 least conditioned upon, resolution of alleged odor problems in the BMSC wastewater  
6 collection and treatment system to the satisfaction of customers. Obviously, the  
7 Commission must be sensitive to the concerns of customers. BMSC shares those  
8 concerns and is self-motivated to take reasonable steps to minimize odors from its  
9 operations. *See* TR at 469-70, 526-28 (Dodds).

10 The Town and HOA generally identify two alleged sources of problem odors: the  
11 CIE Lift Station and the collection system within the Boulders community. *See* Town  
12 BR at 3; HOA BR at 3. The CIE Lift Station is being removed from operation following  
13 a mechanical breakdown over the 2006 Memorial Day weekend. *See* BMSC BR at Brief  
14 Ex. 2. BMSC took steps to minimize and eliminate odors in the Boulders community  
15 even before this rate case was filed. Wade RB (Ex. A-6) at Wade RB Exs. 1-3. The  
16 Town's witness admitted that the problem is much better. TR at 290-96, 320-21  
17 (Francom). BMSC is further willing to engage an independent engineer to conduct yet  
18 another evaluation of the alleged odors from facilities located within Boulders Drive.  
19 Further relief is not warranted on the evidentiary record before the Commission.

20 **A. The Relief Sought By The Town And HOA Is Unsupported.**

21 In their briefs, the Town and HOA seek to portray BMSC as a callous utility  
22 ignoring "severe", "extensive and unrelenting" odor problems, risking the public health  
23 and safety. *See, e.g.*, HOA BR at 4-5, 11; Town BR at 1, 19. Such claims do not match  
24 the evidence in this case, which is why the Town and HOA rely primarily on public  
25 comment by a relatively small number of angry residents and other extra-record materials  
26



1 to support claims of a pervasive and dangerous odor problem. *See, e.g.,* Town BR at 3-4,  
2 6-8; HOA BR at 4-5, 12, Exhibits 1-4.

3 Public comment is not evidence under the standard established by the court in  
4 *State ex rel. Corbin v. Arizona Corporation Comm'n*, 143 Ariz. at 223-24, 693 P.2d at  
5 366-67. BMSC was not able to question customers claiming wastewater from the BMSC  
6 system is backing up into their houses and flowing down the streets, claims the Company  
7 categorically denies. Town BR at 3 (claiming Company responsible for sewage  
8 exploding in customer toilet); HOA BR at 4-5. Previously undisclosed photographs,  
9 newspaper articles and e-mails attached to closing briefs along with customer complaint  
10 forms are also not evidence. *See* HOA BR at Exhibits 1-4.<sup>3</sup> Comments by Company  
11 counsel during the hearing are not evidence. *See, e.g.,* Town BR at 1, 12; HOA BR at 6.  
12 A letter from the Town's Mayor to the Commission Chairmen is also not evidence — the  
13 letter does not even seem to be in the record. *See* HOA BR at 8.

14 The severe odors the Town and HOA claim permeate the community have not  
15 resulted in a single violation of law and no report by any agency charged with regulating  
16 BMSC has been offered to support claims of excessive odor problems. *See* TR at 322-23  
17 (Francom), 354 (Pearson). The only evidence of an odor problem offered by the Town  
18 and HOA is an outdated engineering study and the testimony of the Town Administrator  
19 that he has personally smelled odors. This evidence predates five subsequent engineering  
20 studies and numerous odor and noise control improvements. *See* Wade RB (Ex. A-6) at  
21 2-4, Wade RB Exs. 1, 2 and 3; TR at 468-69 (Dodds). As Mr. Francom testified, the

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22 <sup>3</sup> Several items referenced in the HOA's Brief, were introduced by the HOA for the first  
23 time in its brief. BMSC recognizes that the HOA participated in this rate case without  
24 the benefit of counsel, but Mr. Williams participated in the hearings and certainly should  
25 have been aware that withholding information he intended to introduce and rely upon as  
26 if it is evidence is contrary to due process and prejudicial to BMSC. Had the HOA  
attempted to introduce such evidence, BMSC would have had an adequate opportunity to  
object and/or respond.

1 situation in the Boulders community is much improved, clearly the CIE Lift Station  
2 remains the biggest issue. TR at 290-96, 320-21 (Francom). The CIE Lift Station is  
3 already being removed by BMSC. Beyond that, there is insufficient evidence to warrant  
4 denying or conditioning rate increases on resolution of claimed odor problems.

5 **B. The Claims Made By The Town And HOA Are Too Vague To Support**  
6 **The Relief Sought.**

7 To be absolutely clear, again, BMSC is *not* suggesting that the Commission ignore  
8 the concerns expressed by the Town, the HOA or the customers. As occurred during the  
9 hearing, the Company and other parties should be questioned regarding comments from  
10 customers. BMSC likewise takes these concerns seriously and has been taking  
11 reasonable steps to address customer complaints over odors. However, the HOA and  
12 Town have done a poor job of defining the problem they seek to remedy by withholding  
13 or conditioning rate increases. The Town and HOA have each failed to offer an  
14 appropriate standard to define an "odor problem".

15 All sewer systems emit some odors. TR at 346 (Francom), 638 (Scott).  
16 Governmental agencies set objective standards for utilities like BMSC to meet, and the  
17 Company operates in full compliance with applicable law and regulation. *See* Scott DT  
18 (Ex. S-1), Exhibit MSJ at 4; Wade RB (Ex. A-6) at 6; TR at 480 (Dodds). Specifically,  
19 Maricopa County is the agency charged with primary authority over odors from BMSC's  
20 operations, and no evidence of a violation of any County standard has been presented. *Id.*  
21 *See also* TR at 322-23 (Francom), 354 (Pearson), and 620 (Scott). The Company has  
22 rightfully raised concerns over vague standards that require the Company to satisfy all  
23 customer concerns, possibly well in excess of the applicable governmental standards. *See*  
24 TR at 480-81 (Dodds).

25 The difficulty is particularly acute here, where the Town and HOA allege common  
26 law nuisance claims and various violations of state statutes governing the adequacy of

1 BMSC's service. *See, e.g.,* Town BR at 13-15; HOA BR at 2, 12, 17. To begin with, it is  
2 not clear that the Commission, as opposed to a court, is the proper forum to adjudicate  
3 these types of disputes. The Commission is not a court of general jurisdiction. *See Trico*  
4 *Electric Cooperative v. Ralston*, 67 Ariz. 358, 196 P.2d 470 (1948); *also General Cable*  
5 *Corp. v. Citizens Utilities Co.*, 27 Ariz. App. 381, 555 P.2d 350 (1976). Beyond that,  
6 what standards does the Commission follow to evaluate these allegations? The Town and  
7 HOA offer little beyond full customer satisfaction. How would compliance be measured  
8 if total customer satisfaction were the standard? There is no way to satisfy all customers.  
9 When it comes to claims of inadequate service due to odors, the County's standards  
10 should define whether the Company has an odor "problem". *See* TR at 639 (Scott).

11 **C. The Relief Sought By The Town And HOA Is Unnecessary.**

12 The Town and the HOA are openly using this rate case to leverage concessions by  
13 Company-management to satisfy a relatively small number of customers complaining  
14 about odors. *E.g.,* Town BR at 22-23; HOA BR at 11. However, as explained above,  
15 BMSC has already taken steps to address and minimize odors from its operations—  
16 including, the pending removal of the CIE Lift Station. BMSC is also willing, subject to  
17 appropriate cost recovery, to commence yet another engineering study to evaluate  
18 allegations of continuing odors from facilities located within Boulders Drive. If  
19 additional improvements are warranted, BMSC will make those improvements. Ordering  
20 additional steps, like the specific improvements the Town and HOA seek, which are not  
21 related to ratemaking, and in the absence of any evidence that BMSC's operations violate  
22 the governing standards, would constitute improper interference with management of the  
23 utility. *See Phelps Dodge Corp. v. Ariz. Elec. Power Coop., Inc.*, 207 Ariz. 95, 112, 83  
24 P.3d 573, 590 (2004); *Southern Pacific Co. v. Ariz. Corp. Comm'n*, 98 Ariz. 339, 345,  
25 404 P.2d 692, 696 (1965) (state may regulate with a view of enforcing reasonable rates  
26

1 and charges but is not the owner of the property of public utility companies, and is not  
2 clothed with the general power of management incident to ownership).

3 Claims that BMSC's shareholder will not fund investment or that it lacks  
4 resources are utterly unfounded. Town BR at 22-23 ("BMSC may contend that it lacks  
5 resources"); HOA BR at 11. There is no evidence to support these claims, in fact the  
6 record supports the contrary. BMSC's shareholder has access to significant capital  
7 resources. See Brown DT (Ex. S-9) at 36. BMSC's shareholder is in the business of  
8 deploying capital for investments that earn a reasonable return. TR at 470 (Dodds).  
9 Since acquiring the system, AWRA has invested more than \$1.4 million dollars on  
10 system improvements, many of them intended to control odors and noise. Weber DT  
11 (Ex. A-4) at 4 and Exhibit A; Wade RB (Ex. A-6) at Wade RB Ex. 3. No basis exists to  
12 conclude BMSC lacks or will not commit necessary resources.

### 13 **III. RATE BASE ISSUES IN DISPUTE WITH STAFF.**

14 Three rate base issues are in dispute between BMSC and Staff. Staff's adjustment  
15 to remove just under \$21,000 of rate base is discussed below in Section VI, and Staff's  
16 recommendations regarding the timing of refunds to customers associated with the  
17 termination of the Company's hook-up fee are addressed below in Section VIII. The  
18 Company also disagrees with Staff's adjustment to capitalize legal expenses associated  
19 with negotiating an operating agreement with the Town. These costs were incurred by  
20 the Company in the ordinary cost of business to comply with a Commission order. See  
21 Bourassa RB (Ex. A-2) at 30-31; Weber RB (Ex. A-5) at 9. Therefore, these costs should  
22 be included in operating expenses. The Company faces similar costs on a recurring basis,  
23 making the test year reasonably representative of the operating expenses the Company is  
24 likely to incur during the period new rates will be in effect. *Id.*

1 IV. ALL THREE OF RUCO'S ADJUSTMENTS TO LOWER RATE BASE  
2 SHOULD BE REJECTED.<sup>4</sup>

3 A. RUCO's Deferred Tax Liability Is A Work Of Fiction.

4 The Company's financial information produces a deferred tax asset, an addition to  
5 rate base. *E.g.*, TR at 116-17 (Bourassa). As a result, Staff and BMSC made an  
6 adjustment to increase the Company's rate base. Brown DT (Ex. S-9) at 21; Bourassa  
7 RB (Ex. A-2) at 9-10. RUCO used information from another entity, the parent APIF, and  
8 a made-up allocation methodology to create a deferred tax liability, a deduction to rate  
9 base. According to RUCO, the Commission should approve its adjustment to lower rate  
10 base because utilities "customarily" have deferred tax liabilities. RUCO BR at 8-9. This  
11 is ridiculous. The deferred tax calculations for other utilities have no bearing on the  
12 Company's books and records or the deferred tax calculation for BMSC. TR at 216  
13 (Bourassa), 414-15 (Diaz-Cortez).

14 RUCO next asserts that "there is *no basis* to support the Company and Staff's . . .  
15 recommendation". RUCO BR at 9 (emphasis added). This is rather funny given that the  
16 Company and Staff used information specific to BMSC while RUCO calculated a  
17 deferred tax liability based on the financial information of a sewer utility in Texas, a  
18 hydroelectric plant in Canada and LPSCO, a water and sewer company in Litchfield  
19 Park, Arizona, among the more than 80 entities owned by APIF. *See* TR at 435 (Diaz-  
20 Cortez).<sup>5</sup> What isn't funny, however, is RUCO's attempt to portray the Company as

21 <sup>4</sup> Like Staff, RUCO asserts that certain expenses related to safety training should be  
22 capitalized. RUCO BR at 13. BMSC disagrees with RUCO for the same reasons it  
disagrees with Staff.

23 <sup>5</sup> RUCO's challenge to the use of the Company-specific information is disingenuous. In  
24 the pending rate case for Gold Canyon Sewer Company, an affiliate of BMSC, RUCO  
25 made no adjustment to Staff's calculation of a deferred tax liability, a reduction to rate  
26 base, made by Staff and accepted by the Company using the exact same type of  
Company-specific information. *See* Surrebuttal Testimony of Rodney L. Moore, Docket  
SW-02519A-06-0015, at 3. Of course, in the case of Gold Canyon Sewer Company, use

1 somehow duping Staff into recommending a deferred tax asset. *See* RUCO BR at 9-10  
2 (describing Company's position on deferred income taxes as "highly suspect").

3 Company witness Bourassa explained why a deferred tax asset was not initially  
4 included and why it would have benefited BMSC to have included it from the outset. TR  
5 at 216 (Bourassa). RUCO seems to be suggesting that the Company intentionally left it  
6 out in the hope Staff would ask for the information and make the recommendation so the  
7 Company could then accept it. *See* RUCO BR at 9-10. This is fiction, as is RUCO's  
8 claim that its calculation methodology for deferred income taxes is the "custom in the  
9 industry". RUCO BR at 10. RUCO's witness Diaz-Cortez was unable to identify any  
10 such supporting authority for her deferred income tax calculation. TR at 418  
11 (Diaz-Cortez).

12 **B. BMSC's Working Capital Allowance Should be Zero.**

13 RUCO is right, a lead lag study is the most accurate means of measuring the  
14 working capital requirement. RUCO BR at 10. The formula method, less accurate but  
15 often used for smaller utilities, does not work for BMSC because it bills in advance. TR  
16 at 126-27 (Bourassa). In the absence of a lead lag study, Staff recommended and the  
17 Company accepted zero working capital allowance. *Id.* RUCO recommends negative  
18 working capital, a reduction to rate base of \$87,253. RUCO BR at 10-13.

19 RUCO did not present a lead lag study for BMSC supporting its recommended  
20 level of negative working capital. *See* TR at 427-29 (Diaz-Cortez).<sup>6</sup> RUCO just assumed  
21 the revenue and expense periods for BMSC to come up with its working capital number.

22  
23 of Company-specific data results in a deferred tax liability, reducing rate base, while in  
24 this case the calculation results in a higher rate base.

25 <sup>6</sup> RUCO witness Diaz-Cortez appeared to suggest that she conducted some sort of  
26 modified lead lag analysis but no evidence of such was provided to the Company or  
presented by RUCO in this case.

1 See Bourassa RB (Ex. A-2) at 11; Bourassa RJ (Ex. A-3) at 5. See also TR at 225-228  
2 (Bourassa), 426-34 (Diaz-Cortez). During the hearing, the Company demonstrated that  
3 simple changes in the assumptions lead to significantly different results (TR at 225-228),  
4 and RUCO witness Diaz-Cortez admitted that her calculation was not certain and could  
5 be overstated. TR at 432-33 (Diaz-Cortez). RUCO has not met its burden of proof.

6 C. RUCO Has Not Presented Compelling Reasons To Change The  
7 Commission-Ordered Treatment Of Past Payments For Wastewater  
8 Treatment.

8 Roughly 10 years ago, BMSC purchased up to 320,000 gallons per day of  
9 wastewater treatment from Scottsdale at a cost of approximately \$1.9 million. The  
10 Commission considered the recommendations of Staff, RUCO and the Company  
11 concerning the ratemaking treatment and concluded that income statement treatment, i.e.,  
12 the “operating lease” methodology, was appropriate. See Decision No. 60240 (June 12,  
13 1997) at 1-2 and Decision No. 59944 (December 26, 1996) at 2-3. BMSC and Staff  
14 follow the Commission’s decisions in this case, RUCO does not. Citing “vastly”  
15 changed circumstances, RUCO argues for a change in ratemaking treatment. RUCO BR  
16 at 7. There are no changed circumstances to warrant changing the ratemaking treatment  
17 of expenses incurred a decade ago.

18 Throughout this rate case, RUCO has attacked the ratemaking treatment approved  
19 by the Commission more than a decade ago. See Diaz-Cortez DT (Ex. R-11) at 3-8.  
20 Now, RUCO concludes its argument claiming that the Commission’s approved  
21 methodology “robs ratepayers”. RUCO BR at 8. Although the Company previously  
22 joined RUCO in arguing that the payments to Scottsdale should be capitalized, the  
23 Commission heard the arguments and ordered the payments be passed through the  
24 income statement. See Decision No. 59944 at 5-7. The Commission’s decision is  
25 defensible on the grounds that the contract with Scottsdale allows the Company to buy  
26 wastewater treatment for a fixed period of time without transferring any ownership rights

1 to BMSC. *See* Ex. A-15. Consistent with the operating lease methodology, at the end of  
2 the contract term, BMSC and ratepayers have only the opportunity to seek renewal.  
3 There is nothing to steal from the ratepayers and no reason for the sort of retroactive  
4 ratemaking RUCO is suggesting. RUCO BR at 8 (referring to ratepayers being  
5 “robbed”).

6 RUCO tacitly acknowledges it is engaged in retroactive ratemaking by its repeated  
7 reference to changed circumstances. But none of the so-called changed circumstances  
8 has any relevance to the ratemaking treatment of the payments to Scottsdale. It is true  
9 that the Company’s stock was purchased by AWRA in 2001, and that the name of the  
10 Company was changed, but there has been no change in the Company, its capital  
11 structure or its operations, let alone any change in the contract with Scottsdale. TR at 94-  
12 98 (Bourassa). The loan used to finance the \$1.9 million in payments to Scottsdale has  
13 not changed, it just passed from the prior shareholder to the current shareholder as part of  
14 the stock purchase. *See* Bourassa RB (Ex. A-2) at 28. RUCO witness Diaz-Cortez  
15 testified that the accounting treatment of the payments to Scottsdale has not changed. TR  
16 at 368. There is no reason to change the ratemaking treatment either.

17 The evils of retroactive ratemaking are well known to the Commission and should  
18 not be ignored because RUCO claims that the Company is not prejudiced by its  
19 recommendation. RUCO BR at 6-8. RUCO’s recommendation results in lower rates  
20 than the income statement methodology approved by the Commission a decade ago  
21 around the time the expense was paid. TR at 400 (Diaz Cortez). Reconsideration of the  
22 ratemaking treatment for amounts spent many years ago is unwarranted in this case,  
23 although the Commission might consider alternative methodologies in the event BMSC  
24 seeks recovery in the future of additional amounts paid to Scottsdale.



1     **V.     INCOME STATEMENT ISSUES IN DISPUTE.**

2             **A.     RUCO's Challenge To Property Tax Expense Should Be Rejected,**  
3                     **Again.**

4             In its brief, RUCO argues, as it has in rate case after rate case, that RUCO utilizes  
5     the ADOR formula to determine the level of property tax expense. RUCO BR at 13. The  
6     truth is, all parties are using the ADOR formula. Bourassa RB (Ex. A-2) at 37. *See also*  
7     *Chaparral City Water Company*, Decision No. 68176 (September 30, 2006) at 13. The  
8     only difference is the inputs used, i.e., the annual revenue amounts used in the formula.  
9     Staff and the Company have utilized one year of projected revenues consistent with  
10    Commission precedent. *E.g., Rio Rico Utilities*, Decision No. 67279 at 8; *Arizona Water*  
11    *Company*, Decision No. 64282 at 12-13; *Bella Vista Water Company*, Decision No.  
12    65350 (Nov. 1, 2002) at 16; *Arizona-American Water Company*, Decision No. 67093  
13    (June 30, 2004) at 9-10. RUCO refuses to do so and continues to assert that only historic  
14    revenues should be used.

15            According to RUCO, the Company will over collect property taxes immediately  
16    after rates go into effect because of the lag time between when property taxes are being  
17    incurred and when the tax is actually assessed and paid. RUCO BR at 14-15. Under or  
18    over recovery of an expense is not just common, it is the inevitable by-product of using a  
19    historical test year in an ever-changing marketplace. The methodology repeatedly  
20    approved by the Commission and employed by Staff and the Company utilizes the  
21    revenues recommended in this ratemaking proceeding. As the Commission has found  
22    again and again, it is the most accurate means of setting a level of property tax expense  
23    on a going-forward basis. In contrast, the Commission last held that "RUCO's  
24    backward-looking methodology . . . unfairly and unreasonably understates property tax  
25    expense, and is therefore inappropriate for ratemaking." Decision No. 68176 at 14.  
26    Nothing has changed.

1           **B.     Staff's Recommended Rate Case Expense Is Unfair To BMSC<sup>7</sup>.**

2           The rate case expense the Company has incurred in this case, over \$200,000 to  
3     date, is substantial. *See* BMSC BR at Brief Exhibit 3 (rate case expense through July 31,  
4     2006). This case will take approximately 15 months to prosecute and has involved  
5     substantial discovery, five rounds of pre-hearing testimony, four days of hearings with  
6     five parties actively participating, and extensive briefing of the numerous issues in  
7     dispute, including several complex rate base issues and the technical issues surrounding  
8     alleged odor problems raised by the Town and HOA. Bourassa RB (Ex. A-3) at 31-32;  
9     Bourassa RJ (Ex. A-3) at 17-19; TR at 804-810 (Brown). This rate case has taken just as  
10    long and involved more complex issues in dispute than the recent rate case for *Chaparral*  
11    *City Water Company*, Decision 68176, in which the Commission authorized recovery of  
12    rate case expense of \$285,000. Yet, BMSC is only seeking rate case expense of \$150,000  
13    in this case, substantially less than what it will incur. Nevertheless, Staff recommends  
14    rate case expense of only \$124,800. Staff BR at 21.

15           Staff's opposition to higher rate case expense is premised on its ridiculous position  
16    concerning the impact of the intervention by the Town and HOA, and on its false and  
17    untimely attack on the Company's conduct during the discovery phase of this proceeding.  
18    *Id.* Regarding the interventions, the Company has asserted that it did not contemplate the  
19    intervention or resulting level of additional expense in its initial estimate of rate case  
20    expense. Bourassa RB (Ex. A-3) at 31-32. The Town prefiled the direct and surrebuttal  
21    testimony of its witnesses, introducing complex scientific data into the proceeding, and  
22    participated in discovery. Both the Town and HOA participated extensively in the

23           

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<sup>7</sup> RUCO offered no argument in its brief on this issue, despite challenging the  
24    Company's requested rate case expense in prefiled testimony. The Company addressed  
25    RUCO's recommended rate case expense level in its Closing Brief and there is nothing  
26    further to respond to at this time. To the extent RUCO addresses this issue and  
   introduces new fact or argument, BMSC reserves the right to supplement its brief.

1 hearings and both filed lengthy briefs (offering some 40 pages of combined argument)  
2 and asserting numerous shortcomings on the part of BMSC. Staff opines that the  
3 Company's response to the Town and HOA in this case should have taken no more than  
4 24 additional hours resulting in additional rate case expense of no more than \$4800. Staff  
5 BR at 21. Staff's position is obviously unrealistic.

6 Staff's second reason for denying the requested rate case expense, claims of delay  
7 tactics during discovery, is offensive and should be given absolutely no weight. *Id.* Staff  
8 provides no evidence of these alleged delay tactics, beyond referencing that the Company  
9 objected to some early data requests by Staff. *Id.* Despite now alleging for the first time  
10 that information continues to be withheld (Staff BR at 21, l. 15), Staff never sought the  
11 intervention of the Hearing Division as a result of any of these alleged delay tactics,  
12 opting instead to accept the Company's objection to certain data requests until after the  
13 then-presiding ALJ ruled on an unrelated discovery dispute between the Company and  
14 RUCO. When Staff reasserted its data requests, the Company dropped most of its  
15 objections and information was disclosed. *See* Reply Brief Exhibit 1 attached hereto.<sup>8</sup> If  
16 Staff had an issue with the Company's conduct, it should have brought it up long ago, not  
17 waited to sandbag the Company by casting aspersions in its post-hearing brief. Of  
18 course, Staff has also failed to make any showing that any of these alleged "delays" had  
19 any material impact on the amount of rate case expense incurred or to be recovered  
20 through rates. Thus, Staff's allegations are merely inflammatory and have no bearing on  
21 the issue.

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24  
25 <sup>8</sup> Staff's initial data request was propounded on or around November 8, 2005, and the  
26 Company objected shortly thereafter.

1 **VI. STAFF HAS NOT DEMONSTRATED THAT THE TOTAL COSTS OF**  
2 **AFFILIATED SERVICES ARE UNREASONABLE.**

3 At issue in this rate case are two adjustments recommended by Staff, one to  
4 remove \$20,926 from rate base; and a second to reduce operating expenses by \$21,761.  
5 Bourassa RB (Ex. A-2) at 15, 33; Brown DT (Ex. S-9) at 5-6. The adjustment was made  
6 solely because such amounts represent the “profit” component of transactions between  
7 BMSC and several affiliated entities, primarily AWS. Staff produced no other evidence  
8 and ignored all of the evidence presented by the Company to support the prudence of  
9 these costs, opting instead for a bright line test that discriminates against affiliated  
10 transactions without any reasonable level of scrutiny.

11 Staff spends 14 pages, over 50% of its brief, attempting to support its  
12 recommended one-size fits all approach, and mostly misses the point. Yes, BMSC bears  
13 the initial burden of proving all of its expenses are reasonable. *See* Staff BR at 4 *citing*  
14 *Turpen v. Oklahoma Corporation Commission*, 769 P. 2d 1309 (Okla. 1989). Yes, the  
15 Commission can scrutinize transactions between the Company and its affiliates. *See*  
16 Staff BR at 4 *citing* *U.S. West Communications v. Arizona Corporation Commission*, 185  
17 Ariz. 277, 915 P.2d 1232 (App. 1996). The Commission can scrutinize any transaction a  
18 public utility corporation seeks to recover from ratepayers and, in the case of affiliate  
19 transactions, BMSC agrees that heightened scrutiny is appropriate. TR at 161, 251  
20 (Bourassa); Bourassa RB (Ex. A-2) at 17.

21 In this rate case, Staff inscrutably removed anything it labeled profit on affiliated  
22 transactions.<sup>9</sup> Staff’s “analysis” is not proper ratemaking. Common ownership is not of  
23

24 \_\_\_\_\_  
25 <sup>9</sup> Staff’s adjustment to rate base, for instance, removed \$20,926 from plant-in-service,  
26 \$15,256 of which was booked as CIAC. Bourassa RJ (Ex. A-3) at 9. If Staff’s  
recommendation were adopted, CIAC needs to be reduced by \$15,256.

1 itself a ground for disregarding agreements with affiliates. *See Turpen*, 769 P.2d at 1321  
2 (citations omitted).

3       **A. Staff Failed To Conduct An Actual Analysis Of The Affiliated**  
4       **Transactions.**

5       Staff claims, BMSC “is obviously attempting to shift its burden of production to  
6 Staff.” Staff BR at 7. This is distorted. The Company met its initial burden of showing  
7 that its payments to affiliates were reasonable. Staff then failed to meet its burden to  
8 produce evidence showing why the payments were unreasonable. *See Turpen*, 769 P.2d  
9 at 1321 (attorney general failed to show any specific payment to an affiliate was  
10 unreasonable) and 1323.

11       The Company included the affiliated profit in rate base and in test year expenses in  
12 its initial filing. When sought in discovery, information on the affiliates transactions was  
13 provided.<sup>10</sup> Although it noted the potential for affiliated transactions to be harmful to  
14 ratepayers, RUCO made no adjustment, accepting the inclusion of the affiliated profit in  
15 rate base and expenses as reasonable and necessary to serve the ratepayers. Rigsby DT  
16 (Ex. R-13) at 2-3; TR at 542-43 (Rigsby). Staff, as discussed, removed amounts  
17 identified in data request responses as “profit” from the costs of the affiliated  
18 transactions.

19       Following Staff’s direct testimony, the Company produced additional evidence  
20 demonstrating the reasonableness of the total costs for affiliated transactions included on  
21 the Company’s books and records. *See Bourassa RB* (Ex. A-2) at 34 and TR at 165-66,  
22 255-56 (Bourassa) (comparison to available alternative service providers); TR at 171-72  
23 (Bourassa) (comparison to similar costs incurred by other utilities); *Bourassa RB* (Ex. A-  
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25 <sup>10</sup> As discussed above, the Company initially objected to disclosing the amount of profit  
26 but eventually withdrew its objection without intervention of the Hearing Division.

1 2) at 17-18, 35 and Bourassa Rebuttal Exhibit 2 (comparison to costs of direct services  
2 model). *See also* TR at 250-56. This evidence was more than the mere showing of the  
3 incurrence of the expense Staff portrays, it was evidence sufficient for the Company to  
4 make a *prima facie* showing that the costs as incurred and recorded on the Company's  
5 books and records were reasonable. *See Turpen*, 769 P.2d at 1323.

6 The burden then shifted to Staff, as the party recommending adjustment to such  
7 expenses, "to produce evidence to showing why the payments to affiliates were not  
8 reasonable and should not be allowed." *Id.*, *Central Louisiana Electric Co. v. Louisiana*  
9 *Public Service Comm'n*, 373 So.2d 123 at 127 (La. 1979) (Before the regulatory body  
10 can make adjustments for unreasonably high charges "there must be . . . a factual finding,  
11 or at least a reasonable inference, that the charges are unreasonable."). Staff readily  
12 admits that it presented no such evidence. To the contrary, Staff agreed that the affiliated  
13 business model is "very economically efficient." TR at 771. A determination borne out  
14 by the fact that BMSC saves substantial money every year as a result of the affiliated  
15 services it receives (TR at 168) and by Staff witness Brown's admission that Staff would  
16 not have made the same adjustments if the same services had been provided at the same  
17 cost by non-affiliates. TR at 777 (Brown). *See also* Bourassa RB (Ex. A-2) at 35 and  
18 Bourassa Rebuttal Exhibit 2; Weber RB (Ex. A-5) at 2.

19 Staff predicts that BMSC will argue that Staff could have audited the affiliates'  
20 books. Staff BR at 8. This is true, and it is of no account that Staff unilaterally  
21 concluded that it could not audit those books and records. *Id.* at 8. If Staff felt that an  
22 audit of the books and records of affiliates was necessary, Staff should have requested it  
23 and, if BMSC objected, a ruling by the presiding ALJ would have decided the matter.  
24 *See* TR at 247-48 (Bourassa). Nothing prevented Staff from heightened scrutiny of  
25 affiliate transactions, except Staff itself. *Id.* *See also* Staff BR at 8.

1 To further cover-up its failure to produce any evidence, Staff also criticizes the  
2 Company because it was unable to produce more or better evidence, including evidence  
3 of bids obtained by other service providers. *See e.g.*, Staff BR at 6-8. The undisputed  
4 evidence was that competitive bids were unavailable. TR at 474-75. *See also* Weber RB  
5 (Ex. A-5) at 5. The fact that this evidence was impossible to obtain does not render the  
6 rest of the Company's evidence insubstantial. Staff certainly had sufficient evidence to  
7 determine that the business model employed by the Company's shareholder results in a  
8 well-run and efficient utility and that the affiliated transaction costs would have been  
9 reasonable if BMSC paid such amounts to one or more non-affiliates. TR at 779  
10 (Brown).

11 **B. Where Is The Harm?**

12 Staff goes to great lengths to portray the "Algonquin" business model as unfair  
13 and intended to overburden ratepayers (yet, at the same time, wants the Commission to  
14 require the Company to continue to use the shared services business model for BMSC  
15 and other utilities Algonquin owns/operated in Arizona). *See* Staff BR at 9 *citing*  
16 *Washington Utilities & Transportation Commission v. Washington Water Power*  
17 *Company*, 24 P.U.R. 427 (1978) ("public utility has no right to impose a heavier burden  
18 than that which would be justly borne"); Staff BR at 10, n. 66 (discussing Commission  
19 power to prohibit utility and affiliate from evading review); Staff BR at 11 *citing* *Central*  
20 *Louisiana Electric Co.*, 373 So.2d 123 at 126 (addressing manipulation of electric utility  
21 by parent "for the purpose of creating excessive profits at the expense of the ratepayers").  
22 But Staff misconstrues the central holding in both cases it relies on, namely, that the  
23 Commission's responsibility when regulating rates is to "assure that they are just and  
24 reasonable." *Washington Utilities*, 24 P.U.R. at 13; *Central Louisiana Electric Co.*, 373  
25 So. 2d at 127. Staff's oft-recited mantra that the parties are affiliated and therefore the  
26 charges are unreasonable does not make it so. The evidence shows just the opposite.

1           Staff also suggests that the Commission should collapse all of the “Algonquin”  
2 family of companies into one entity, ignoring corporate law and the rights of unregulated  
3 parties to a return on their investment in the name of preventing “an injustice to  
4 ratepayers.” Staff BR at 13. To support its position Staff again misconstrues the law and  
5 ignores the evidence. Arizona strongly supports the treatment of corporations as separate  
6 entities. *See, e.g., Arizona Public Service Co. v. Arizona Corp. Comm’n*, 155 Ariz. 263,  
7 267, 746 P.2d 4, 8 (App. 1987) (Declining to pierce the corporate veil because the  
8 Commission offered no evidence of undercapitalization, fraud, misconduct or  
9 impropriety in the management of the affiliated companies.); *Deutsche Credit Corp. v.*  
10 *Case Power & Equipment Co.*, 179 Ariz. 155, 160, 876 P.2d 1190, 1195 (App. 1994)  
11 (“The concept of a corporation as a separate entity is a legal fact, not a fiction.”). The  
12 general rule is that “corporate status will not be lightly disregarded.” *Keams v. Tempe*  
13 *Technical Institute, Inc.*, 993 F.Supp. 714, 723 (D.Ariz 1997).

14           The Commission should follow the general rule here because no evidence of  
15 fraud, misconduct, ‘injustice’ or impropriety in the management of the affiliated  
16 companies exists. There is no evidence BMSC or its affiliates have sought to evade  
17 review, and Staff has not presented evidence of “excessive profits”. Staff’s view is that  
18 \$1.00 of profit and \$100,000 of profit are equally excessive and unreasonable unless  
19 earned by a non-affiliate. TR at 777, 779 (Brown). The evidence is just the opposite, it  
20 shows that the “Algonquin” business model results in a broader range of service to the  
21 utility and its customers at lower cost than could otherwise be achieved under a more  
22 traditional structure. Staff is so convinced of the benefits accruing from the business  
23 model that it wants the Commission to require BMSC to continue to benefit from the  
24  
25  
26



1 model even after the profit is removed. Staff BR at 14.<sup>11</sup> See also TR at 779, 789  
2 (Brown).

3 Staff is also wrong that profit on affiliated transactions is “guaranteed”. Staff BR  
4 at 3. To start, every dollar the Company seeks to recover from ratepayers is subject to the  
5 intense scrutiny of the ratemaking process. See e.g., *U.S. West Communications*, 185  
6 Ariz. at 282, 915 P.2d at 1237. If there were evidence that profit was being manipulated  
7 or was excessive, the Commission would not allow it to be recovered through rates. *Id.*  
8 See also TR at 178 (Bourassa). Second, nothing is guaranteed under the ratemaking  
9 process. Expenses can go up or down, but rates stay the same until a subsequent order of  
10 the Commission. The Commission could approve the level of test year expenses and  
11 BMSC might not have sufficient income to cover all its expenses, including the projected  
12 profit on the cost of affiliated services. Since the costs incurred by affiliates are not  
13 fixed, these entities end up having capital and resources at risk. See TR at 269  
14 (Bourassa).

15 C. **The Only Evidence Before The Commission Shows That BMSC’s**  
16 **Payments To Affiliated Companies Are Reasonable – Therefore They**  
**Should Be Allowed.**

17 Staff asks the Commission to find that the costs of affiliated services were  
18 unreasonable based on nothing other than the fact that the parties are related. This is not  
19 proper ratemaking. *Turpen*, 769 P.2d at 1321. In short, BMSC met its initial burden of  
20 showing *prima facie* that its payments to AWS were reasonable. *Id.*, at 1323. The  
21 burden then shifted to Staff to show why the payments were not reasonable and should

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22 <sup>11</sup> The Commission’s role is to ensure that public service corporations deliver adequate  
23 utility services at reasonable rates. See, e.g., *Southern Pacific Co. v. Ariz. Corp.*  
24 *Comm’n*, 98 Ariz. 339, 345, 404 P.2d 692, 696 (1965) (regulation does not generally  
25 include the power to manage incident to ownership). Absent exigent circumstances, the  
26 Commission waits until the utility comes before the agency for new rates and charges to  
scrutinize the reasonableness of the costs incurred. Staff has no reason or justification to  
seek a ruling unfavorable to BMSC. Staff BR at 14.

1 not be allowed. *Id.* Staff did not even attempt to meet its burden. Staff relied solely on  
2 its pre-determined opinion that because BMSC and AWS were affiliated, BMSC's  
3 payments to AWS were an "injustice." All the evidence is to the contrary. All the  
4 evidence shows that the payments were reasonable. Indeed, all the evidence shows that  
5 the provision of services by the affiliated entities provided economic benefits to the  
6 ratepayers. Accordingly, the Commission should reject Staff's recommendations.  
7 *Central Louisiana Electric Co.*, 373 So.2d 123 at 127 (To make adjustments for  
8 unreasonably high charges "there must be . . . a factual finding, or at least a reasonable  
9 inference, that the charges are unreasonable.")

## 10 **VII. CAPITAL STRUCTURE AND COST OF CAPITAL.**

### 11 **A. RUCO's Hypothetical Capital Structure Should Be Rejected.**

12 RUCO has consistently used hypotheticals to lower the revenue requirement in  
13 this case. As discussed above, RUCO assumed that the purchase of treatment from  
14 Scottsdale will be treated as an asset to lower operating expenses and fabricated a  
15 deferred tax liability from the parent company's consolidated financial information to  
16 reduce rate base. In part three of RUCO's Hypothetical Trilogy, Mr. Rigsby used the  
17 parent company's capital structure (43 percent debt and 57 percent equity) rather than a  
18 "true hypothetical capital structure." TR at 552 (Rigsby); RUCO BR at 16.<sup>12</sup> Staff and  
19 the Company offer a third alternative—the Company's capital structure. Staff BR at 22.  
20 It should be adopted.

21 The purpose of RUCO's hypothetical capital structure is to bring BMSC more  
22 closely in line with the capital structures of the industry. *E.g.*, TR at 552 (Rigsby).  
23 RUCO has now eliminated every shred of utility-specific information from the cost of

24 <sup>12</sup> BMSC agrees that adoption of RUCO's position concerning the ratemaking treatment  
25 of costs paid to Scottsdale for wastewater treatment would require adoption of RUCO's  
26 first alternative capital structure. *See* RUCO BR at 16.

1 capital analysis. RUCO's use of a hypothetical capital structure is really nothing more  
2 than an effort to hide the downward manipulation of the return on equity. TR at 552  
3 (Rigsby) (testifying that without a hypothetical capital structure the results of RUCO's  
4 cost of capital analysis would be too high).

5 RUCO's claim that the Company's cost of equity should be low because the lack  
6 of any debt in its capital structure leads to decreased financial risk is overstated. *Id* at 16-  
7 17. The Commission chose to treat the Scottsdale treatment debt as an expense, not an  
8 asset, but the debt is still there and must be repaid. Bourassa DT (Ex. A-1) at 14;  
9 Bourassa RB (Ex. A-2) at 40. Rates are set at a level that provides an opportunity to earn  
10 a certain level of operating income if operating expenses are first recovered—nothing is  
11 guaranteed.

12 **B. BMSC's ROE Should Be 11 Percent.**

13 Much of the revenue in dispute in rate cases rests on the subjective wisdom of  
14 experts over the "fair" rate of return. Fortunately, there are guiding legal principles. A  
15 regulated utility is entitled to earn a return on equity that is sufficient to allow the utility  
16 to attract capital on reasonable terms, and is commensurate with returns on investments in  
17 other enterprises having corresponding risks. *Bluefield Water Works & Improvement Co.*  
18 *v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679, 692-93 (1923); *Fed. Power*  
19 *Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Duquesne Light Co. v.*  
20 *Barasch*, 488 U.S. 299, 314-15 (1989). Unfortunately, the application of these legal  
21 standards has been supplanted by textbook platitudes justifying the blind application of  
22 esoteric equations. The staged results of highly technical financial modeling have  
23 substituted for any sort of "economic reality" check.

24 Take, for example, RUCO's single argument on ROE in its closing brief: RUCO's  
25 recommended ROE is "fair" and "generous" because Mr. Rigsby's sample companies  
26 have more risk than BMSC. RUCO BR at 17. These sample companies include

1 American States and Aqua America, large, well-established utilities with credit ratings  
2 and publicly traded stock, with millions of customers, hundreds of millions to billions of  
3 dollars of assets, with hundreds of millions of dollars in revenues from multiple sources.  
4 Bourassa DT at 25-28; Bourassa RB at 46-47. These corporate giants are said to be more  
5 risky because the only risk to be considered is financial risk. Rigsby DT 51-55; Rigsby  
6 SB at 11. According to RUCO, all water and sewer utilities face the exact same risks.  
7 Rigsby DT at 20. No evidence or analysis supports this opinion, and "economic reality"  
8 would dictate otherwise. An investor doesn't need financial modeling to compare an  
9 investment in Aqua America or American States to BMSC, nor can there be legitimate  
10 dispute over which has more investment risk.<sup>13</sup>

11 Staff's cost of capital analysis could also do with a dose of reality. In this case,  
12 Staff has a new cost of capital witness and he was provided all the "resources" he needed  
13 to adopt Staff's approach to determining the ROE. TR at 683 (Chaves). The Company's  
14 criticisms of Staff's methodologies is set forth in prefiled testimony and in the  
15 Company's closing brief and needs not be repeated again. For now, it is the results that  
16 cast doubt on the methods.

17 For several years, Staff's analysis has resulted in increasingly lower rates of  
18 return, which Staff then justified as being the result of historically low interest rates.  
19 *E.g.*, Ex. A-21 at 6-7. Now, however, interest rates (and estimated betas) are much  
20 higher than they were a few years ago, yet Staff's ROE's have hardly changed. TR at

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21  
22 <sup>13</sup> Staff and RUCO may attempt to portray an investment in BMSC as the same as an  
23 investment in Aqua American or American States because the Company's shareholder is  
24 a large income fund with some \$800 million of utility assets in numerous locations across  
25 North America. This is misplaced. APIF is the same as the investor, i.e., stock  
26 purchaser, in those large publicly traded utilities and in this case we are determining a fair  
return on APIF's investment in BMSC. Therefore, the risk of an investment in BMSC  
should be compared to the risk of buying stock in Aqua American or American States, for  
example. BMSC is not comparable to those entities, however.

1 710-11 (Chaves) How can a 100 plus basis point increase in interest rates have virtually  
2 no impact on the cost of equity if low interest rates justified lower ROEs a mere three  
3 years ago?<sup>14</sup> The only answer Staff could muster is that despite the increase in interest  
4 rates and betas, its market risk premium in its CAPM does not support higher ROEs. TR  
5 at 719-22 (Chaves).

6 Of course, Staff and RUCO level similar criticisms at the Company's cost of  
7 capital analysis. Staff accuses Company witness Bourassa of manipulating the same  
8 financial models and of making subjective decisions to "artificially inflate" the ROE.  
9 E.g., Staff BR at 26. Throughout the case, Staff has criticized Mr. Bourassa's risk  
10 premium and comparable earnings analysis. E.g., Chaves DT (Ex. S-4) at 40-42; Chaves  
11 SB (Ex. S-5) at 3. What Staff and RUCO do not and cannot argue though is that the  
12 Company's cost of capital analysis is grounded on the blind application of the results of  
13 financial models. Nor do they or can they argue that the Company treats every water  
14 utility in the United States as having the same business risk. This is true because, of all  
15 the cost of capital witnesses, only Mr. Bourassa took the results of his financial modeling  
16 and subjected them to an "economic reality" check. In a process where everything is  
17 contested, the Company's 11% ROE is the only thing that can survive a reality check.

18 **VIII. BMSC SHOULD BE AUTHORIZED TO MAKE REFUNDS OF HOOK UP**  
19 **FEES TO RATEPAYERS.**

20 Staff and BMSC agree that \$833,367 of hook-up fees previously paid should be  
21 refunded to customers. Staff BR at 16. Staff and the Company also agree that refunds  
22 should be made equally to all ratepayers. *Id.* Staff further suggests new rates not go into  
23 effect until the refunds are made and notice provided to Staff. *Id.* This might  
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25 <sup>14</sup> During the hearing, Mr. Chaves admitted to a 200 point increase in U.S. Treasuries  
26 from mid-2003 to January 2006. TR at 685 (Chaves).

1 inadvertently prejudice the Company in the event a Commission order is issued near the  
2 end of a month. To avoid this, BMSC suggests that the order require that refunds be  
3 made *in* the same month new rates go into effect with notice at the same time to Staff.  
4 The Commission has more than adequate means to remedy any non-compliance with  
5 such a requirement.

6 RUCO argues that the Company's current rate design should be retained but  
7 makes no other argument concerning rate design in its brief. RUCO BR at 16. The  
8 HOA, seemingly joined by the Town, wishes to revive Staff's hastily withdrawn  
9 suggestion that BMSC be ordered to use the hook-up fee funds to address the "odor  
10 problem." Town BR at 22-23; HOA BR at 10-11. This is unnecessary. Financial  
11 resources to make necessary system improvements are not lacking. *See* Brown DT (Ex.  
12 S-9) at 36; TR at 470 (Dodds).

13 RESPECTFULLY SUBMITTED this 5th day of September, 2006.

14 FENNEMORE CRAIG, P.C.

15  
16 By  \_\_\_\_\_

17 Jay L. Shapiro  
Patrick J. Black

18 3003 North Central Avenue, Suite 2600  
Phoenix, Arizona 85012

19 Attorneys for Black Mountain Sewer Corporation

20 ORIGINAL and thirteen (13) copies of the  
21 foregoing were delivered  
22 this 5th day of September, 2006 to:

23 Docket Control  
24 Arizona Corporation Commission  
25 1200 W. Washington St.  
Phoenix, AZ 85007

1 COPIES hand delivered  
2 this 5th day of September, 2006 to:

3 Dwight D. Nodes  
4 Assistant Chief Administrative Law Judge  
5 Hearing Division  
6 Arizona Corporation Commission  
7 1200 W. Washington St.  
8 Phoenix, AZ 85007

9 Keith Layton  
10 Staff Attorney  
11 Legal Division  
12 Arizona Corporation Commission  
13 1200 W. Washington St.  
14 Phoenix, AZ 85007

15 Daniel Pozefsky, Attorney  
16 Residential Utility Consumer Office  
17 1110 W. Washington, Suite 220  
18 Phoenix, AZ 85007

19 And COPIES mailed  
20 this 5th day of September, 2006 to:

21 Boulders Homeowners Association  
22 Mr. Robert E. Williams  
23 P. O. Box 1170  
24 Carefree, AZ 85377

25 M. M. Shirtzinger  
26 34773 N. Indian Camp Trail  
Scottsdale, AZ 85262

Thomas K. Chenal, Esq.  
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7047 E. Greenway Parkway, Suite 155  
Scottsdale, AZ 85254

By: Maria San Jose

**REPLY BRIEF**  
**EXHIBIT 1**



**REDACTED**

---

**From:** SHAPIRO, JAY  
**Sent:** Tuesday, February 07, 2006 1:42 PM  
**To:** 'Keith Layton'; Dan Pozefsky  
**Subject:** RE: Black Mountain Sewer DR Objections

It is now even less a problem. BMSC will endeavor to respond to all of the subject data requests by the end of this week.

---

**From:** Keith Layton [mailto:KLayton@azcc.gov]  
**Sent:** Tuesday, February 07, 2006 1:41 PM  
**To:** SHAPIRO, JAY; Dan Pozefsky  
**Subject:** RE: Black Mountain Sewer DR Objections

No problem Jay.

---

**From:** SHAPIRO, JAY [mailto:JSHAPIRO@FCLAW.COM]  
**Sent:** Tuesday, February 07, 2006 12:29 PM  
**To:** Dan Pozefsky; Keith Layton  
**Subject:** RE: Black Mountain Sewer DR Objections

I cannot appear at a procedural conference on the issue until conferring with my clients which is unlikely to happen in time for a call today. Of course, my clients might be willing to provide the requested information so allowing me to confer with them is in everyone's interests.

---

**From:** Dan Pozefsky [mailto:DanP@azruco.gov]  
**Sent:** Tuesday, February 07, 2006 12:05 PM  
**To:** Keith Layton; SHAPIRO, JAY  
**Cc:** Crystal Brown; Gordon Fox; Janice Alward  
**Subject:** RE: Black Mountain Sewer DR Objections

Keith,  
I am available today after 1:15 and until 3:15. Tomorrow may be difficult but Thursday all day I am available.  
Dan

---

**From:** Keith Layton [mailto:KLayton@azcc.gov]  
**Sent:** Tuesday, February 07, 2006 12:01 PM  
**To:** SHAPIRO, JAY  
**Cc:** Dan Pozefsky; Crystal Brown; Gordon Fox; Janice Alward  
**Subject:** Black Mountain Sewer DR Objections

9/5/2006

Jay,

Staff would like to schedule a Procedural Conference regarding the Company's objections to CSB 1.52, amended CSB 1.52, CSB 4.1, CSB 5.1 and CSB 7.3. Below is a brief summary of Staff's efforts to determine the profit margins included in certain affiliate transactions.

In CSB 1.52, Staff requested information on the return or profit included in billings of each affiliate. Following the Company's objection, Staff requested information on how prices were determined for the transactions, i.e. fair market value ("FMV"). In the Company's response to amended CSB 1.52, Mr. Bourassa stated that the transactions were not based on a FMV determination, but were based on cost plus "a small, but appropriate 'operating margin'." Mr. Bourassa provided several schedules that included costs allocated to Black Mountain for the affiliates' staff time. However, Mr. Bourassa did not include the operating margins.

In CSB 4.1, Staff submitted a follow-up DR specifically requesting the operating margin component included in each transaction. The Company renewed its objections to the original CSB 1.52, and did not provide any additional information.

In CSB 5.1, Staff asked for a detailed schedule of affiliate employee costs included in the transactions. The Company objected again, but provided some additional cost schedules.

Finally, in CSB 7.3, Staff provided its calculations of the profit margin based on cost data provided by the Company. Staff requested the Company to verify its calculations. The Company stated that Staff's calculations were incorrect, but provided additional cost data.

Staff believes that the profit component of the affiliate transactions are relevant and may lead to admissible evidence. Please let me know your availability today and tomorrow before 1:30 p.m. for a procedural conference.

Keith Layton  
Attorney, Legal Division  
Arizona Corporation Commission  
1200 W. Washington Street  
Phoenix, Arizona 85007  
Ph: 602-542-6030  
Fax: 602-542-4870  
klayton@azcc.gov

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9/5/2006